

ST 96-52

Tax Type: SALES TAX

Issue: Books and Records Insufficient
Unreported/Underreported Receipts (Non-Fraudulent)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE)	
OF THE STATE OF ILLINOIS)	No.
)	IBT No.
v.)	NTL No.
)	NTL No.
TAXPAYER)	NTL No.
Taxpayers)	NTL No.
)	Charles E. McClellan
)	Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

APPEARANCES: Alan Osheff, Special Assistant Attorney General, for the Department of Revenue; Kevin J. Mix for TAXPAYER

Synopsis:

This matter comes on for hearing pursuant to the taxpayer's timely protest of Notices of Tax Liability (NTL) issued to TAXPAYER by the Department of Revenue dated June 23, 1995 for Retailers' Occupation Tax ("ROT") and Use Tax. These Notices of Tax Liability are numbered as follows: XXXXX. The issues are whether the Department met a minimal standard of reasonableness in making its determination of additional tax due for the periods July 1990 through December 1994, and, if so, whether the under-reporting of gross receipts from sales during the audit period as determined by the Department was due to fraud. Following the submission of all

evidence and a review of the record, it is recommended that this matter be resolved in favor of the Department on both issues.

Findings of Fact:

1. The Department's *prima facie* case against TAXPAYER, including all jurisdictional elements, was established by the admission into evidence of the Correction of Returns, showing tax due of \$80,114, penalty of \$27,574 and interest of \$25,813 for a total liability due and owing in the amount of \$133,501, Tr. 9/19/96 pp. 6-10; Dept. Grp. Exs. No. 1-9) and the Revised Liability Report (Tr. 9/19/96 pp. 11; Dept. Grp. Exs. No. 10).

2. Included in the assessments were fraud penalties assessed under 35 ILCS § 120/4 for the periods beginning July 1, 1990 through November 30, 1994. (Dept. Grp. Exs. No. 5-8).

3. The assessments described in paragraphs 1 and 2 above were the result of the Department's original audit. (Tr. 9/19/96 p. 10; Dept. Grp Ex. No. 10).

4. Following the issuance of the NTL's described above, and at the request of the taxpayer for an audit in detail, the case was returned to the Department's Audit Bureau for re-audit. (Tr. 9/26/96 pp. 42, 43; Dept. Grp Ex. No. 10).

5. At the conclusion of the of the re-audit a Revised Liability Report was prepared showing the following assessments:

Additional taxes due	\$127,952
Interest due through 8/19/96	53,137
Interest due on late filing, late payment and civil fraud penalties	3,742
Civil fraud penalty	42,856
Delinquent penalty	1,541
Late filing and late payment penalties	<u>5,549</u>
Total due	\$234,777

(Dept. Grp Ex. No. 10).

6. The Department's auditor was never given cash register tapes showing sales made during the audit period. (Tr. 9/26/96 p. 48).

7. Because the taxpayer told the Department's auditor that taxpayer's records had been destroyed, the auditor had to project sales for the audit period. (Tr. 9/26/96 pp.45, 48).

8. To obtain inventory (cost of goods sold) figures, the auditor circularized taxpayer's suppliers to obtain documentation of inventory purchases made during the audit period. (Tr. 9/26/96 pp. 42-45; Dept. Exs. No. 12-15).

9. The auditor then used the markup percentages obtained from the taxpayer's federal income tax returns to markup the cost of goods sold figures obtained from taxpayer's suppliers thereby projecting taxpayer's sales during the audit period. (Tr. 9/26/96 p. 42; Dept. Ex. No. 11)).

10. The auditor then compared the projected sales figures to the sales figures reported by the taxpayer on its monthly sales tax returns for the audit period. (Tr. 9/26/96 p. 46; Dept. Ex. No. 11).

11. The resulting calculations showed that taxpayer had unreported receipts of about \$20,000 per month on average during the audit period. (Tr. 9/26/96 p. 46; Dept. Exs. No. 10, 11).

12. The resulting calculations also show that the taxpayer understated its receipts from the sale of non-food items during the audit period by a minimum of 149% (Sept. 1992--Dec. 1992) to a maximum of 1,804% (July 1990--Aug. 1990) and by 358% for the entire audit period. (Dept. Ex. No.11).

13. During the audit period, taxpayer's purchases of non-food items exceeded the non-food sales taxpayer reported by a minimum of 78% (Sept. 1992--Dec. 1992) to a maximum of 1,328% (July 1990--August 1990) and by 229% for the entire audit period. (Dept. Ex. No.11).

Conclusions of Law:

The record in this case, shows that this taxpayer has failed to demonstrate by the presentation of testimony or through exhibits or argument, evidence sufficient to overcome the Department's *prima facie* case of tax liability under the assessments in question. Accordingly, by such failure, and under the reasoning given below, the determination by the Department that TAXPAYER owes the assessments shown on the Corrections of Return as revised by the re-audit and shown in the Revised Liability Report must stand as a matter of law. In support thereof, the following conclusions are made:

ISSUE # 1

The first issue to be decided is whether the Department met a minimal standard of reasonableness in making its determination of additional tax due for the periods July 1990 through December 1994. When a taxpayer fails to supply the Department with records to substantiate its gross receipts, the Department is justified in using the markup method to estimate the taxpayer's gross receipts, and, in doing so, the Department is required only to meet a minimum standard of reasonableness. Mel-Park Drugs, Inc. v. Department of Revenue, 218 Ill.App.3d 203 (1st Dist. 1991). In this case, the Department's

auditor testified that she was not given cash register tapes (Tr. 9/26/96 p. 48), and there is nothing in the record to indicate that she was given any other books and records recording the taxpayer's sales during the audit period. She, therefore, resorted to the markup method by marking up the taxpayer's inventory purchases which she had obtained by solicitation from the taxpayer's suppliers. She obtained a markup percentage from copies of the taxpayer's federal income tax returns covering the audit period. Using this data, she projected the taxpayer's sales for the months included in the audit period. (Tr. 9/26/96 p. 42; Dept. Exs. No. 11-15). The same method was used by the Department in another case in which the court held that it met the required minimum standard of reasonableness. Vitale v. Department of Revenue, 118 Ill.App.3d 210 (3d Dist. 1983). Therefore, since the taxpayer in this case provided no books and records to the Department to substantiate the sales figures it reported on its retailers' occupation tax returns, the Department was justified in using the markup method, and, by so doing, the Department satisfied the requirement to meet a minimum standard of reasonableness.

At the hearing in this case, the Department introduced into evidence the NTL's issued to the taxpayer, the Department's correction of return documents, the auditor's workpapers and the Revised Liability Report generated during the re-audit showing the markup calculation. These documents, coupled with the uncontroverted testimony of the Department's auditor, show that the Department's determination was not arbitrary or unreasonable, but rather was based on reasonable statistical assumptions. The Department's technique

was made necessary because the taxpayer did not produce adequate books and records for examination. See Vitale, *supra* at 212. As the Department's auditor testified, she made her determination on the best available information. (Tr. 9/26/96 p. 45). That is all that is required. Central Furniture Mart v. Johnson, 157 Ill.App.3d 907 (1st Dist. 1987).

A corrected return prepared by the Department is deemed *prima facie* correct and the Department establishes its *prima facie* case by having the corrected return admitted into evidence. (35 ILCS 120/4) Central Furniture Mart v. Johnson, 157 Ill.App.3d 907 (1st Dist. 1987). Therefore, when the Department had the NTL's, corrected returns, the Revised Liability Report and the re-audit workpapers introduced into evidence (Dept. Exs. No. 1-15), its *prima facie* case was established.

A taxpayer cannot overcome the Department's *prima facie* case merely by denying the accuracy of the Department's determination. Central Furniture Mart v. Johnson, *supra*. Simply questioning the Department's assessment or denying its accuracy is not enough. Quincy Trading Post v. Dept of Revenue, 12 Ill App.3d 725 (4th Dist. 1973). A taxpayer can overcome the Department's *prima facie* case by producing competent evidence identified with the taxpayer's books and records. Vitale, *supra*, at 213. In this case the taxpayer presented no documentary evidence whatsoever to show that the Department's determination was arbitrary, capricious or unreasonable. The taxpayer did introduce testimony to the effect that it had suffered substantial losses due to rioting, burglaries and flooding (Tr. 9/26/96 p. 18, 21, 25, 37), but it introduced no police reports or

insurance claims or other evidence documenting any such losses. (Tr. 9/26/96 p. 37, 46). The Department's auditor testified that she had asked about inventory shrinkage but had been shown no documents relative to inventory losses. (Tr. 9/26/96 p.46, 47). The only documentary evidence introduced by the taxpayer were a large number of invoices relating to inventory purchases (Taxpayer Ex. No. 1), a large number of canceled checks (Taxpayer Ex. No. 2), and an accountant's summary schedules of inventory purchases during 1993 and 1994. (Taxpayer Exs. No. 3, 4). No testimony or other evidence was introduced that would show how these exhibits controvert the Department's determination of unreported gross receipts. Absent any competent documentary evidence, to controvert the Department's *prima facie* case, the Department's determination as reflected in the Corrections of returns as modified by the auditor's Revised Liability Report must be sustained.

ISSUE # 2

The second issue to be decided is whether the under-reporting of sales determined by the Department was due to fraud. Where civil fraud under Section 4 of the Retailers' Occupation Tax Act (35 ILCS § 120/4) is alleged, the Department must show intent. Intent for this purpose can be shown by circumstantial evidence. Vitale, *supra* at 213. In the Vitale case, *supra*, the court found the necessary intent from a number of facts, including the following: the taxpayer had understated his gross receipts by as much as 200%; in one year the taxpayer's purchases exceeded his sales by 46%; finally, the taxpayer failed to maintain business records. Vitale, *supra* at 213.

In this case, the taxpayer understated its receipts from the sale of non-food items by as much as 1,804% (9 times the percentage understatement in Vitale). For the entire audit period, the taxpayer understated its receipts from the sale of non-food items by 358% (almost twice the percentage understatement in Vitale). Also, for the audit period, the taxpayer's purchases of non-food items exceeded its sales by 229% (about 5 times the percentage of excess in Vitale), and, as in Vitale, the taxpayer failed to maintain business records of sales for the entire audit period. Even if losses did occur as taxpayer alleged thereby causing the Department's determination to be overstated, and there is no documentary evidence to that effect, to use that allegation to explain the difference between taxpayer's reported sales and the sales calculated by the department for the entire audit period stretches credulity beyond the breaking point. The record in this case contains clear and convincing circumstantial evidence of intent to commit fraud. Therefore, the Department's assessment of fraud penalties must be sustained.

WHEREFORE, for the reasons stated above, it is my recommendation that the Department's assessment of tax as calculated in the re-audit and shown in the Revised Liability Report be upheld in full, the assessment of fraud penalties as adjusted in the re-audit must be sustained, with interest and late filing and late payment penalties recalculated accordingly.

Date

Charles E. McClellan
Administrative Law Judge